Will Bonds Be Hotter Than Income Stocks in 2017?

Description

In recent years, generating a high income return has not been particularly challenging. A range of stocks and bonds across the globe have offered yields ahead of inflation, which has left investors with a wide range of options in order to generate a decent income. However, the ultra-loose monetary policies of recent years could now be coming to an end. And with higher inflation set to be a feature of the coming years, shares and bonds could offer very different levels of return.

Popular assets

Since the global financial crisis, the world has experienced a deflationary period. This has meant that even ultra-low interest rates across much of the developed world have not caused inflation to move to dangerous levels. As such, obtaining an income return which is positive in real terms has been relatively straightforward.

Bonds have remained popular for this very reason, since even low single-digit yields on investment grade securities have left investors with positive real-terms returns. And since uncertainty regarding global economic growth has been relatively high, bonds have been a popular asset to own.

Bonds have also been prominent parts of investment portfolios in recent years because of low interest rates. Other things being equal, bond prices move inversely to interest rates. This means that as interest rates have fallen, bond prices have increased. This has left many investors with sizeable capital gains from their bonds in recent years.

Changing times

However, low inflation and low interest rates are unlikely to remain in place for long. The election of Donald Trump as US President is likely to mean higher spending and lower taxes. This potent mix may stimulate the US economy and lead to even lower levels of unemployment. However, a by-product of it could be higher inflation. This would reduce the income return of bonds and shares in real terms. And since many investment grade bonds have relatively low yields, their returns could even be negative once inflation has been factored in.

At the same time, bond prices may fall. Interest rates are likely to rise in response to higher inflation and this could cause capital losses for bondholders. While the pace of interest rate rises is not known, the scale of spending on infrastructure and defence in the US could mean that inflation rises rapidly and policymakers respond quickly by raising interest rates.

Takeaway

While the outlook for bonds is somewhat uncertain, income stocks could provide a tonic for investors. Although they may be hurt by rising interest rates and some companies may struggle to match earnings growth or dividend growth to inflation, income stocks are likely to significantly outperform bonds in 2017 and beyond. They generally offer higher yields and so should be able to better cope with higher inflation, while an increasingly 'risk-on' attitude adopted by investors may mean that funds move from bonds and into shares. The end result could be rising share prices over the long run.

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peterstephens